Monday Morning Update May 14, 2018

The Fed – the May meeting of the FOMC came and went, with little fanfare or new news. The target for year-end 2018 is still 2.125% for the Fed's target rate (two more moves). The target set by the Fed for 2019 is 2.875% (three moves). The target for 2020 is set at 3.375% (two moves). And then the rate is forecast to move lower in 2021 by 50 bps. The Fed sees the economy slowing enough in 3 years to justify a rate adjustment lower from its target level at that time.

Inflation – traders and investors have seen CPI data, PPI data and PCE data; all show inflation growth rates are not at alarming levels. Not even close. CPI has been running around 30 bps higher then the Fed's favorite indicator, the PCE. With year-over-year core CPI moving lower last month, the Fed's PCE should stay under 2.00%.

Treasuries – The yield of 3-month Libor has been flat for the past 5-6 weeks. Libor has priced in 2 more moves by the FOMC this year, one in June and the last one in September. The 2-year Treasury is thinking 3 moves can still happen. The spread between Fed Funds target and the 2-year is now at 85 bps. Either the yield of the 2-year has to stop going higher, or the markets have to reprice a fourth move taking place in December. This will upset equities if the repricing takes place. The spread between 2-year and 10-year (the yield curve), can easily flatten to around 20 bps, and still show no suggestion of a recession anytime soon.

The S&P 500 – it has taken awhile, but the S&P is finally back above its 50-day moving average. Staying above 2678 will let the S&P revisit 2790. If traders like the S&P at 2790, they will do their best to retest the old January high of 2873. Then a complete revaluation, and repricing will take place. The P/E will continue to be the key variable for S&P 500 valuations.

Crude Oil – for the oil industry, a test of wills is at hand. Does oil at $70 a barrel entice you to forgo your promises to reduce production and, instead, increase production to capture the higher revenue ? Does $70 a barrel entice the shale producers to forego their promises to practice more fiscal restraints, and turn on the spigots and take the money off the table ? Arguable only a small percentage of the move in oil prices from $55 a barrel to $70 a barrel is geopolitical related. Supply has been shrinking, and demand has been increasing. Taking Venezuela and Iran supply out the market makes a difference. Saudi Arabia and Russia seem committed to their production cut agreements.

Municipals – 5-year munis are still very expensive, relative to Treasury yields. And 10-year muni ratios continue to be the most expensive relative to Treasuries in the past 12 months. Money taxed at a 21% Fed tax rate can do better in corporate bonds versus tax-exempt munis, on a yield and interest income basis, with maturities under 7 years. Investors at the 31% Fed tax rate or higher still get a few bps more in income with munis versus corporates, especially considering the State income tax liability applicable to corporates. The month of June will see $20 billion in coupon payments and maturities; supply is only projected to be $13 billion.

Corporates – the appetite for risk remains high, as evidenced by the performance of corporate spreads. One new wrinkle to watch is the shift away from the High Yield bond market (capital markets) and toward the bank loan market. Less publically tradable HY bonds trying to meet the demand for what has been an insatiable demand for anything with yield and manageable default rate histories. Another factor supporting spreads staying tight is the strength of the junk market; the total number of companies rated B3 or lower is a smaller percentage of the overall HY market. And lastly, default rates are forecast to decline, and stay well under 2% into next year. The yield difference between Investment Grade and High Yield was +230 bps last Friday. Tight. But lots of extra income each year, with default rates presumed to be extremely low. But investors buying a HY ETF are getting about 100bps less in income than what the HY index shows as a current market yield. Packaged products like ETFs and mutual funds designed to replicate the HY corporate bond market do a very poor job of replicating the yield of the index inside an ETF. The ICE BofA Merrill Lynch BB – B High Yield corp index is yielding a 5.78%. The Bloomberg Barclays Corp High Yield Index is yielding a 6.27%. The ETF HYG yields 5.08%. The ETF JNK yields 5.45%.

The US Dollar – The 2% move higher in the USD will have some effect on S&P 500 earnings, just not yet sure how much. Maybe higher interest rates here in the USA are finally giving support to the US Dollar.

Global Rate Policies – Bloomberg shows the probability of the ECB changing its monetary policy from its target of a negative 40 bps is extremely low all the way out to 1st quarter 2019. The same can be said for the Bank of England, the Bank of Japan, of Canada, of Sweden, of India, of Mexico, at least thru year-end 2018.

Consumer Sentiment – Consumer spending is good. The tax laws are now more favorable to businesses. Regulatory barriers are falling. All good reasons for continued strong readings in Small Business Optimism.